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No. 89-530

IN THE
Supreme Court of the United States
OCTOBER TERM, 1989

PORTLAND GOLF CLUB,
Petitioner,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

ARGUMENT

I. SECTION 512(a)(3) DEEMS UNRELATED EXPENSES TO BE "BUSINESS" IN CHARACTER.

A. The Government's position seeks inconsistently to tax all unrelated business income but allows deductions for only part of the unrelated business expenses.

The Government complains that Petitioner seeks a "unique" deduction for social clubs, which conflicts with Congress' intent in Section 512(a)(3) to impose higher tax burdens on clubs. (G.Br. 12-14, 22-23, 25, 35, 46.) But the fact is that Section 512(a)(3) is a "unique" statute that broadens the definition of unrelated business taxable income and deductible expenses beyond the definition provided in the general rule applicable to most tax exempts and beyond the definition generally used for tax-

able entities. The Treasury proposed Section 512(a)(3) and Congress adopted its proposal substantially unchanged. Petitioner is not to blame, for Congress intentionally adopted the special definition found in Section 512(a)(3) in order to subject to tax all the net unrelated income of a social club or a VEBA, not just its net income from an unrelated trade or business (as defined in Section 513) regularly carried on.

In broadening the income subject to tax beyond the normal boundaries of a trade or business, Congress also broadened the deductible expenses beyond the normal boundaries of a trade or business. This is clear from both the statutory terms and the legislative history. (See Pet. Br. 16-21.) However, the Government is unhappy with the results of Section 512(a)(3) and its broad definitional provisions; it erroneously attempts to expand taxable unrelated income through the Section 512(a)(3) definition, while narrowing the deductible expenses to those allowed under Section 512(a)(1) by the application of the profit motive test.

Apparently relying on the "allowed by this chapter" phrase in Section 512(a)(3), the Government seeks (G.Br. 20-21) to reintroduce the profit motive requirement, either through Section 162 or some alleged "common law" of taxation. But it is contradictory to conclude that the specific language of Section 512(a)(3) eliminates the trade or business (and included profit motive) requirement by defining the activity as a business, and then reintroduces that requirement through a broad reading of the general phrase "allowed by this chapter." Contrary to the Government's contention (G.Br. 22), the profit motive requirement of Section 162 is frequently modified by other provisions of the Code.[1] The words

[1] *E.g.*, *Frank* v. *United States*, 577 F.2d 93 (9th Cir. 1978) (IRC § 7701(a)(26) eliminates § 162 profit requirement for certain officials); *Trustees of Graceland Cemetery Improvement Fund* v. *United States*, 515 F.2d 763 (Ct.Cl. 1975) (nonprofit organization need not always have profit motive for § 162 deduction); *Golden Rule Church Assn.* v. *Commissioner*, 41 T.C. 719, 728-731 (1964) (activity may be "trade or business for purposes of Treas. Reg. § 1.501(c)(3)-1(e) even though it is a nonprofitable operation); Treas. Reg. § 1.482-1(a)(2) (trade or business is "any trade or business activity of any kind"); cf. IRC § 513 (separate activity is trade of business even if carried on within larger aggregate of activities).

"trade" or "business" occur thousands of times in the Code and Regulations, with no uniform definition or meaning.

Even the Government admits that "Section 512(a)(3) allows a social club to deduct expenses directly connected with the production of all gross income (other than exempt function income), including expenses connected with activity that does not rise to the level of a trade or business." (G.Br. 18-19). Once having admitted this, the Government seeks to deny such deductions by requiring that they satisfy the "profit motive" test of Section 162. While this Court has held that profit motive is a key factor in determining the existence of a Section 162 trade or business (*Commissioner* v. *Groetzinger*, 480 U.S. 23, 35 (1987)), it has also admonished that analysis of the term "trade or business" must be confined to the specific Code provision and the legal and factual circumstances involved (*id.* at 27 and fns. 6-8). If a profit motive is a requirement for determining whether an activity is a trade or business, and Section 512(a)(3) deductions do not require a trade or business, then it follows that Petitioner need not have a profit motive to deduct its expenses directly connected to its unrelated business activity.

Even if Section 512(a)(3) required a profit motive test, the statutes would not yield the Government's desired approach of taxing the income, but limiting the deductions. If an activity does not have a profit motive and does not otherwise qualify as a trade or business, it must be categorized for tax purposes as something else. In the

case of an exempt social club, if the activity is not an unrelated business activity it must be categorized as an exempt activity; there are no other categories. The income of an exempt activity is not subject to tax as provided in Section 501(a) and expenses are not deductible as provided in Section 265. However in the case of an exempt social club, this type of recategorization simply cannot occur because the category of exempt activities is narrowly defined to include only income from members in payment for exempt purpose goods and services and investment income permanently set aside for charitable purposes.

The Government's reliance on cases involving the trade or business question as it applies to individuals is misplaced, as the statutory structure results in a different tax treatment. If an activity of an individual is not entered into with a bona fide profit motive and otherwise does not qualify as a trade or business, the activity is a hobby or personal activity. The income from the activity is always taxable, but if the activity is a hobby, the expense deductions are limited to the income from the activity under Section 183; if it is a personal activity the expenses are not deductible as provided by Section 262. There is no basis whatsoever to treat an exempt social club under the rules applicable to taxable individuals and ignore the statutes specifically applicable. The Sixth Circuit in *Cleveland Athletic Club* v. *United States*, 779 F.2d 1160, 1165 (1985) properly rejected the Government's position because "it would tax all the Club's unrelated business as called for by the statute, but only allow a limited portion of the deductions allowed by the statute."

B. The Government cannot read the "business" definition out of Section 512(a)(3) by claiming an inadvertent "historical use" occurred.

The Government uses (G.Br. 27) a novel "historical use" theory of statutory construction for attempting to explain away the clear terms of Section 512(a)(3),

which defines "unrelated *business*" taxable income as statutorily defined gross income less certain statutorily defined deductions. Under the Government's novel canon of construction, for which it cites no authority, the words "unrelated business" are to be given no effect because it is alleged they were unthinkingly carried over from the 1950 unrelated business tax provisions. This *ad hoc* interpretive approach violates the most basic precept that every word in a statute is required to be given effect, and general words in the statute may not be interpreted so as to nullify specific terms or phrases. *E.g.*, *Weyerhaeuser S.S. Co.* v. *United States*, 372 U.S. 597, 600-601 (1963); see *United States* v. *HCSC Laundry*, 450 U.S. 1, 5-6 (1981).

C. Petitioner's position gives full weight to the "allowed by this chapter" phrase in § 512(a)(3).

There is no merit to the Government's contention (G.Br. 29) that Petitioner's interpretation of Section 512(a)(3) reads the "allowed by this chapter" requirement out of the statute, because our test is assertedly "always satisfied" and "is no test at all." While all directly connected unrelated expenditures will always satisfy the "business" test of both Sections 512(a)(3) and 162, some will still be disallowed as deductions for failure to satisfy other Section 162 tests—for example, they will not be "ordinary," or "necessary," or will not be "paid on incurred," or substantiated. Our interpretation gives meaning to every phrase in the statute, while the Government's construction would nullify Section 512(a)(3)'s definition of certain expenses as "business" in character.[2]

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[2] The Government is similarly mistaken in attempting to interpret the "otherwise deductible" phrase in certain legislative history documents so as to nullify the extensive discussion in those same documents of the rule that all income and deductions are deemed to be business income and deductions. *See Technical Explanation of Treasury Tax Reform Proposals, Hearings on the Subject of Tax*

D. Congress' purpose was to deny deductions for exempt function losses, not for excess expenses from taxable unrelated activities.

Contrary to the Government's contention (G.Br. 25-30), Petitioner's position does not ignore or circumvent Congress' intent in enacting Section 512(a)(3). At the time of the bill, social clubs paid no income tax on either their membership income or their nonmembership income (including investment income). Congress and the Treasury were concerned that when a tax was imposed on investment income, exempt clubs would simply increase their services (and their costs) or decrease their membership revenues, and use the resulting membership loss to offset their investment income. Such a result had already happened in the case of membership organizations (including clubs) which were taxpaying corporations, and the same bill contained a provision (now Code Section 277) to prevent such offsetting of membership losses against taxable investment income. S. Rep. No. 91-552, 91st Cong., 1st Sess. 74-75 (taxable clubs); *id.* at 71-72 (exempt clubs).

In Section 512(a)(3), Congress intended to prevent the soon-to-be-taxable Section 501(c)(7) clubs from similarly offsetting membership losses against investment income. Indeed, that is the whole thrust and purpose of the language in Section 512(a)(3) dividing income and deductions into two discrete pools, the exempt function income and deduction pool, and the unrelated business income and deduction pool. Each pool is treated separately for tax purposes. Section 277 provides a similar division for fully taxable club corporations. There is no dispute that losses from the exempt function pool may not offset income from the unrelated business pool. That

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Reform Before the Comm. on Ways and Means, 91st Cong., 1st Sess., Part 14, at 5059, 5139-5140 (April 22, 1969). Accord, Department of the Treasury, *Tax Reform Studies and Proposals* (House Ways & Means Comm. & Senate Finance Comm. Jt. Pub. Feb. 5, 1969), Pt. 3, at 324.

is not occurring in this case, and that issue is a mere red herring here.

It is significant that nothing in the legislative history of either Section 512(a)(3) or 277 even suggests that Congress intended that expenses arising from unrelated business *taxable* activities could not be used to offset income from other unrelated business *taxable* activities. No published rule or regulation of any kind prevents a *taxable* club from offsetting its excess expenses on one taxable activity against income from another taxable activity, just as all taxable corporations commonly do. The Government's attempt to apply a different rule to the taxable activities of the Petitioner corporation here is unfair and unauthorized.

Indeed, for eleven years after enactment of Section 512(a)(3), the Government interpreted its Proposed Regulations[3] to require aggregation of all unrelated income and expenses in one hotchpot, and paying tax only on any resulting net income. The Government's argument that the Proposed Regulations support its current position is contrary to its admitted consistent interpretation of those Regulations from 1971 through 1981, and is repugnant to the basic premise of those Regulations that income and deductions from all taxable unrelated activities must be aggregated. See *Cleveland Athletic Club* v. *United States*, *supra*, at 1166; *North Ridge Country Club* v. *United States*, 89 T.C. 563, 579-580 (1987).[4]

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[3] Section 1.512(a)-3(b)(3).

[4] The Government's theory further contradicts the historical circumstances of the enactment of Section 512(a)(3). In 1969, the major problem contemplated when investment income was made subject to tax an attempt by social clubs to offset losses on *member* business—which have always been considerable in social clubs—against taxable investment income. In 1969, an exempt club was only allowed to engage in insubstantial *nonmember* business and still retain its exempt status—no more than 5 percent of gross receipts. Rev. Proc. 71-17, 1971-1 C.B. 683. Congress could hardly have been

II. PROFIT MOTIVE DOES NOT REQUIRE TAXABLE INCOME.

A. Petitioner's losses arose from allocations stipulated to be reasonable, and are similar to accelerated depreciation and other preferences allowed to business corporations.

The Government acknowledges (G.Br. 41-42) that many Fortune 500 corporations have continuously reported tax losses, even though they earned economic profits, and that those losses have not been disallowed on the basis that they had no profit motive. The Government rationalizes this by claiming that those losses only resulted from what it terms "preferences". But that term is merely a name for deductions which have a greater tax effect than economic effect. In the instant case, Congress and the IRS have provided social clubs a "preference" in the form of the gross-to-gross method of allocating fixed expenses, which may at times apportion expense deductions that exceed actual economic costs to the unrelated business activity. It is this Government-granted preference—stipulated to be "reasonable" here (J.A. 28)—not any effort by Petitioner to "manipulate" the deduction (G.Br. 13), which resulted in Petitioner's reporting continual losses from its unrelated business, while earning substantial economic profits.[5]

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concerned with clubs offsetting losses from such small nonmember activities against taxable investment income, and indeed the Treasury allowed such offsets continuously until 1981. Despite the Government's claims of substantial tax avoidance, the tax benefits of the deductions here were less than $5,300 for two years.

[5] While acknowledging that profit motive requires "economic profits," the Government attempts to explain away the use of that term in the many tax shelter cases as meaning "profits apart from the tax benefits generated by the shelter itself", without "disregard[ing]" fixed expenses. While the Government is correct in stating that tax benefits may not be taken into account in determining profit motive, it is wrong in suggesting that economic profit requires a tax profit rather than cash flow. The cases cited in Petitioner's Main Brief, pp. 39-42, as well as IRS' own Manual and the interpretations of these authorities by the law review authors

Far from being the sinister plot to avoid taxable income which the Government's brief attempts to portray, the use of the gross-to-gross allocation method has been authorized by the IRS since at least 1969, and has sound tax administration purposes. This method is by far the simplest method for calculating unrelated fixed expense deductions. Given the fact that there are over 50,000 tax-exempt social clubs, most of which have volunteer treasurers who have limited time, and no special expertise in accounting calculations, such a simple allocation method is a practical necessity. In fact, the actual cost allocation method, which IRS prefers, required a certified public accountant over 100 hours to prepare here. (RT 54; see J. Exs. 15-O, 16-P, 17-Q; J.A. 85.) While the gross-to-gross method sometimes yields substantial deductions —as here—this is not always the case, and that relative imprecision must be balanced against administrative practicalities.[6]

(*id.*), demonstrate that profit for profit motivation purposes means gross receipts less variable expenses—*viz.*, cash flow.

The Government erroneously relies (G.Br. 35-36) on several cases—all derived from *Hirsch* v. *Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963), and *Weir* v. *Commissioner*, 109 F.2d 996, 998 (3d Cir. 1940)—to show that "profit for profit motivation purposes means "taxable income." However, as the Ninth Circuit explained in *North Ridge Country Club* v. *Commissioner*, 877 F.2d 750, 756, fn.9 (1989), *Hirsch* did not involve a situation like here where the taxpayer had net income under several economic accounting methods, but had reported a loss using a permissible tax accounting system. Indeed, in *Hirsch* the taxpayer neither expected nor received any gross income subject to tax and thus could not have a profit motive. The *North Ridge* court therefore properly treated the "taxable income" statement in *Hirsch* as inapplicable. Similarly, none of the other cases cited by the Government (G.Br. 35-36) involved situations even remotely resembling that here. Indeed, in *Weir* the taxpayer purchased stock in a corporation which owned his residence for $25,000, later sold the stock for $3703, yet the court still found a profit motive.

[6] The Government repeatedly contends that Petitioner "is trying to have it both ways" by computing its taxable income using the

During the past two years the House Subcommittee on Oversight of the IRS has been considering changing the methods for making allocations of fixed expenses, but it has never suggested prohibiting use of the gross-to-gross method. Instead, it has suggested formulas which would arbitrarily disallow portions of allocated costs if the physical facility in question was not used more than 25 or 50 percent of the time for unrelated activities.[7] These proposals would deny any fixed allocations to Pe-

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gross-to-gross method on its return, while computing profit using different methods for profit motive purposes. (See G.Br. 12, 34-35, 37, 44-46.) Yet the Government itself has successfully argued for use of different accounting methods for different tax purposes in a social club exemption case. In *Pittsburg Press Club* v. *United States*, 536 F.2d 572 (3d Cir. 1976), after remand, 579 F.2d 751 (1978), after second remand, 615 F.2d 600 (1980), the court adopted the Government's position that the taxpayer club engaged in business for purposes of denying Section 501(c)(7) exemption on the basis of profit consisting of gross income over variable expenses. This was so even though the club had tax losses in several years as a result of deducting variable and fixed costs.

Here, the Government's Proposed Regulations required deduction of allocated fixed costs, and the gross-to-gross method was stipulated to be reasonable, so Petitioner properly took such deductions like any economically profitable business which generates tax losses through accelerated depreciation, depletion, or other preferences. The unanimous Tax Court opinion in *North Ridge, supra*, at 573, properly rejected the Government's "symmetry" argument: "While there is a certain pleasing symmetry to * * * [the Government's] argument, we do not believe it determinative of the question before us. * * * We note that it is * * * [the Government which] allows the deduction of the indirect fixed costs against the nonexempt income; costs which otherwise would be borne in their entirety by the club membership. * * * The record as a whole makes it apparent that petitioner was seeking profit from these activities * * *.

[7] See Draft Report of Subcommittee on Oversight, H. Ways & Means Comm., June 24, 1988 BNA Daily Tax Report, at L-24; Summary of Main Issues in Possible Modification of Oversight Subcommittee U.B.I.T. Options, April 2, 1990 BNA Daily Tax Report.

titioner, since by law its gross income from active unrelated business may not exceed 15 percent of gross receipts under penalty of losing its tax exemption. However, any adjustment in the use of this tax "preference" should be left to Congress, and should not be arbitrarily capped by this Court using a special profit motive formula crafted by the Court for social clubs.

B. Petitioner's large and financially successful business is not a hobby or personal activity entailing special profit motivation rules.

The Government erroneously attempts to "closely analog[ize]" the activities of Petitioner with a hobby or other personal activity in order to demonstrate that the profit motive test which should apply to tax exempt clubs should be stricter than that applicable to regular business corporations. (See G.Br. 36-39.) It cites cases and statutes (*e.g.* IRC §§ 183 and 280A) dealing with individual hobbies and personal activities, and argues that the strict profit motive test assertedly applicable to those situations should be used here. We need not consider whether a stricter test exists, because those authorities involve individuals, not corporations, and are irrelevant here.

Petitioner is not an individual pursuing a hobby, but is rather an exceedingly successful business corporation, with about $1.5 million in total gross revenues per year, and over $1 million in retained earnings. (J.Exs. 4-D, 5-E.) During a 12-month period in the years in issue, its unrelated food and beverage business had a profit of over $90,000 using the per-person method for allocating fixed expenses (J.A. 81.); it had net income of about $20,000 per year using the "actual use" method of allocating fixed expenses preferred by IRS. (J.A. 29) Petitioner is a business corporation which is taxed as a corporation under Code Section 11 on all its income, save specified exempt function income. It is farfetched and erroneous for the Government to contend (G.Br. 36-39)

that Petitioner should be governed by tax rules designed to apply to individuals who attempt to offset losses on personal vacation homes, or yachts, or a speculative gambling venture, or a horse petting farm, against taxable individual income. Indeed, the only other authorities cited (G.Br. 37) are Code Sections 183 and 280A, which by their specific terms do not apply to corporations.

In reality, the ordinary profit motivation rules, applied by the Tax Court in situations involving economic entities such as corporations and partnerships, should govern this case. In the case of corporations, there is very little authority on profit motivation, because corporations are presumed to have a profit motive.[8] The Government has cited no authority whatsoever for its proposition (G.Br. 30-31) that a corporation may deduct excess expenses arising from one of its loss activities against income from another profitable activity only if the loss activity has a nexus to the profitable activity. The fact is that a corporation may have New York City real estate generating continuous tax losses in the same corporate structure with its profitable Las Vegas gam-

[8] That ordinary business corporations are not denied deductions on the basis that an activity does not have a profit motive is shown by the absence of any trade or business test in Section 165, which provides deductions for corporate losses, although Section 165(c)(1) imposes a trade or business requirement for individuals. The requirement was omitted because "trade * * * or business does not require proof in the case of corporate taxpayers * * * [since] it is presumed that any transaction entered into by a corporation is either for profit or in connection with a trade or business. Parker, *Deductions and Credits*, 76-77 (1967 ed.) (footnotes omitted); accord, B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, par. 5.03 (5th ed.); S. Surrey and W. Warren, *Cases on Federal Income Taxation* 338 (1960 ed.). Only where a corporation engages in an activity which is primarily for the personal benefit of its officers or shareholders will expenses from the activity be disallowed. B. Bittker and J. Eustice, *supra* (citing cases). The expenses here were stipulated to be those required to provide services to nonmember customers in order to generate economic profits, and were not personal expenditures of the members.

bling casinos, and net out the losses and profits on its annual form 1120 corporate income tax return.[9] All Petitioner seeks is similar tax treatment for the deductions in its taxable unrelated business pool.

CONCLUSION

For the reasons stated, the judgment of the Ninth Circuit should be reversed.

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[9] Taxable corporations commonly acquire "loss" corporations for precisely that purpose: in that limited acquisition situation, there are certain rules restricting the acquiring corporation's use of the losses of the acquired corporation. See Code Sections 269 and 382. Indeed, the Code even allows consolidation of income and losses among affiliated corporations. See Sections 1501-1505.